IN THE

Supreme Court of the United States

October Term, 1964

No. [redacted] 134

Paragon Jewel Coal Company, Inc., *Petitioner*,

v.

Commissioner of Internal Revenue.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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INDEX

AUTHORITIES

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COMMISSIONER OF INTERNAL REVENUE.

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PARAGON JEWEL COAL COMPANY, INC., your petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit, entered in the above-entitled case on March 17, 1964.

OPINIONS BELOW

The opinion of the Tax Court (CIR Pet. App. 28-72)[1] is reported at 39 T.C. 257. The opinion of the court below (Appendix A, *infra*, pp. A1-A5) is reported at 330 F. 2d 161.

JURISDICTION

The judgment of the court below (Appendix C, *infra*, p. A6) was entered on March 17, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether the decision below nullifies this Court's ruling in *Parsons* v. *Smith*, 359 U.S. 215, which held that the depletion deduction is available only to the owner of a capital interest in mineral in place.

2. The Tax Court found as facts that certain taxpayers, mining coal under contract with petitioner, lessee of the coal, (1) had no obligations under petitioner's coal leases and paid no royalties or taxes on the property or the mineral interest; (2) acquired no legal title either to the coal in place or to the coal after it was mined; (3) sold none of the coal to anyone other than to the lessee and were not entitled to do so; (4) were not concerned with the sale price the lessee received for the coal; (5) mined only as directed by the lessee; and, on conflicting evidence, (6) had no right to mine any specific area to exhaustion.

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[1] The Commissioner of Internal Revenue filed two briefs and appendices below, one as respondent in the consolidated case of the Merritts *et als.*, and one as petitioner in the present case to review the decision of the Tax Court favorable to Paragon Jewel. The latter appendix, hereinafter cited as "CIR Pet. App.," contains the opinion of the Tax Court. We have filed nine extra copies thereof with our petition. Accordingly, pursuant to the second paragraph of Rule 23(1)(i), we are not reprinting the Tax Court's opinion as an appendix of our own.

There was no evidence that lessee ever executed any sublease of the mineral interest to its contractors.

The question presented is whether, having regard to the rule of *Parsons* v. *Smith*, 359 U.S. 215, where this Court declared that the depletion deduction was available only to the owner of a capital interest in mineral in place, the court below erred in holding that, on the foregoing facts, all of which were inconsistent with any ownership of or capital investment in the coal in place on the part of the contractors, they were none the less entitled to depletion on the footing that they shared an economic interest in the coal with the lessee, petitioner here.

3. Section 611(b)(1), I.R.C. 1954, continuing a provision in force since 1918, provides that, in the case of a lease, the deduction for depletion "shall be equitably apportioned between the lessor and lessee." Section 631(c), I.R.C. 1954, denies the lessor of coal any deduction for depletion, and defines "owner" for the purpose of computing the depletion allowance as any person who owns an economic interest in coal in place, including a sublessor. Section 614(a), I.R.C. 1954, defines "property" for the purpose of computing the depletion allowance in the case of mines as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 631(b), I.R.C. 1954, defines an "owner" for the purpose of computing the depletion allowance as any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber.

The question presented is whether, in view of those provisions, there is any warrant in law for the holding below that a lessee of coal must share its depletion allowance with those with whom it has contracted to mine the coal and who plainly were not sublessees.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in Appendix C, *infra*, pp. A7-A10.

STATEMENT

The following facts were found by the Tax Court:

A. Paragon's leases and its mining contractors

Petitioner, Paragon Jewel Coal Company, Inc. (hereafter "Paragon"), acquired by assignment written leases on the coal in and underlying land in Buchanan County, Virginia. The leases required the lessee to mine either all or 85 per cent. of the minable coal in and underlying the leased tracts. Paragon assumed all the obligations of the lessees under the leases, and was obligated to pay annual minimum royalties, tonnage royalties, and land taxes. (CIR Pet. App. 55.) The individuals specified below, who mined the coal under contracts with Paragon, did not assume any of Paragon's obligations under its leases and paid no royalties or taxes on the property or the mineral interest (CIR Pet. App. 58). The contractors "acquired no legal title either to the coal in place or to the coal after it was mined" (CIR Pet. App. 62).

After acquiring the leases, Paragon made substantial investments necessary for mining, processing and marketing the coal, including the construction and maintenance of a tipple, processing equipment, a power line, a railroad sidetrack with four spurs running under the tipple, and a road from the tipple around the mountain close to the outcrop line of the coal over which coal could be trucked from the mines to the tipple. Paragon did not mine the coal itself, but contracted out the mining to various individuals and firms who were to mine the coal at their own expense and deliver the coal to Paragon's tipple. Paragon would then clean and size the coal and sell it on the market. (CIR Pet. App. 55-56.)

Among Paragon's independent contractors were Standard Smokeless Coal Company, whose partners during the period here in question were Robert Lee Merritt, G. Wesley Merritt, James O. Watson, and Jack D. Merritt (CIR Pet. App. 56); Kyva Mining Company, a firm composed from time to time of G. Wesley Merritt, Jack D. Merritt, Watson, and Virgil Bowling (CIR Pet. App. 56); Farwest Coal Company, whose partners were Bowling and the three Merritts (CIR Pet. App. 57), and certain other firms and individuals (CIR Pet. App. 56-57).

The three Merritts, Watson, and Bowling, were petitioners in the consolidated proceeding in the Tax Court (CIR Pet. App. 28, 29), and were similarly petitioners in the consolidated proceeding below.

B. Paragon's mining contracts

The contracts between Paragon and the several contractors above named were oral, and were performed as follows:

As Paragon extended its road around the side of the mountain, the prospective contractor would be taken to various proposed sites for mine openings, which Paragon would usually face up. After the contractor selected a particular site, Paragon's representative would pick out the general area in which the contractor could mine. The contractor agreed to mine the coal in that area and to deliver it to Paragon's tipple at his own expense. The contractor was required to provide his own men and equipment, and, if necessary, to extend a road from Paragon's road to the mine portal. All expenses of opening and operating the mine were borne by the contractor. (CIR Pet. App. 58.) The contractor agreed either to provide his own power or to purchase it from Paragon, and also agreed to pay Paragon for engineering services inside the mine rendered by Paragon's engineer (CIR Pet. App. 59).

Paragon's engineer provided the contractor with a mine map showing the general direction in which the mine should progress, and showing where barriers between adjacent mines should be left so that one contractor did not break through into the mine of the adjacent contractor. The engineer extended the projections from time to time. Paragon insisted on all contractors using the same engineer, who could project a system for mining all the coal under its leases without leaving unrecovered pockets of coal and to prevent one contractor from breaking into the mine of another contractor. The contractors were required to obtain Paragon's permission before pulling pillars as they retreated from an area which had been mined. (CIR Pet. App. 59-60.)

The contractors were not obligated to mine any specific amount of coal and were not specifically given the right to mine any particular area to exhaustion. The projections of the mines were based somewhat on the speed with which the contractor worked. If one contractor mined more rapidly, or if an adjacent mine ceased operating, he might be given the right to pierce the indicated barrier. (CIR Pet. App. 61.)

C. Were the contracts terminable?

The Tax Court found (CIR Pet. App. 60) that "The contracts were not made for any specific period of time and nothing was said about the right to terminate by either party at the time the agreements were entered into."

The record contains two exhibits (CIR Pet. App. 75-90), both of which were sworn statements submitted by G. Wesley Merritt to the District Director of Internal Revenue at Richmond, Va., one on behalf of the Kyva Mining Company, the other on behalf of Standard Smokeless Coal Company, the affiant plus his partners in the two firms comprising all of the individual petitioners in the Tax Court and in the court below. In both of these

statements, which were sworn to and filed long before the present proceedings were commenced in the Tax Court, it was stated (CIR Pet. App. 79, 87) that "The partnership's contract with Paragon embraced the following understanding between the partners and Paragon," listing nine lettered items, of which the last (CIR Pet. App. 80, 87) was:

> "(i) The contract specified the right of termination by either party at any time, but the question never arose between the partnership and Paragon."[2]

To continue with the Tax Court's findings:

Numerous contractors ceased mining from time to time as they were unable to mine coal profitably or for other reasons. Such contractors were not permitted to remove buildings from the premises but usually took their equipment with them unless it was under lien to Paragon. It was anticipated by both parties that a contractor would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit and as long as the contractor employed proper mining methods and produced coal meeting Paragon's specifications. (CIR Pet. App. 60-61.)

D. Other provisions of the contracts

Paragon agreed to pay the contractor a fixed price per ton for coal delivered to its tipple, less 2½ per cent for rejects. It was understood that the price might vary from time to time. The price paid to Paragon to the contractors did vary, depending somewhat on the general trend of market prices for the coal over extended periods and to some lesser extent on labor costs. But price changes made by Paragon to the contractors were always prospec-

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[2] The italics shown at CIR Pet. App. 80, 87, were not in the original documents; pencilled underscoring appears to have been added later.

tive and the contractors were notified several days in advance of any price change so that they always knew the price they would get for coal when they delivered it to the tipple. The contractor had no further control over the coal after it was delivered to Paragon, and did not know how or for what price Paragon sold or otherwise disposed of the coal. (CIR Pet. App. 58-59.)

During the years here involved, Paragon took all merchantable coal produced by the various contractors operating on Paragon's leased property and paid the contractors the price fixed by Paragon. Paragon sold very little of its coal under contract and the prices it obtained for coal varied quite frequently. If Paragon was unable to take all of the contractors' coal either because of lack of coal cars or because its tipple was full, the contractor would fill his own bins and then shut down until Paragon could take more coal. (CIR Pet. App. 61.)

The contractors completed their obligations under the contracts by delivering the coal to Paragon's tipple and thereupon became entitled to their compensation for mining the coal by virtue of Paragon's personal covenant to pay them so much per ton. The contractors were not concerned with the sales price Paragon received for the coal. (CIR Pet. App. 61.)

The contractors paid nothing for the privilege of mining coal other than their investment in equipment, roads, and buildings and their cost in opening the mine and mining the coal. They acquired no legal title either to the coal in place or to the coal after it was mined. The coal as delivered to Paragon's tipple by the contractors was not in a state which was salable to the consumer but had to be washed, graded, and treated in order to be salable on the consumer market. All such processing was done by Paragon at its processing plant. The contractors sold none of the coal to anyone other than Paragon, and were not entitled to do so. (CIR Pet. App. 62.)

E. The depletion issue in the Tax Court

Paragon claimed percentage depletion on its income tax returns for the taxable years ending September 30, 1955, 1956, and 1957. Standard Smokeless and Kyva claimed percentage depletion on their partnership returns for the calendar years 1954, 1955, and 1956. The Commissioner disallowed both sets of deductions, whereupon Paragon and the several partners in Standard Smokeless and Kyva separately filed petitions in the Tax Court contesting the resultant deficiencies. All the petitions were consolidated for hearing. (CIR Pet. App. 29, 62-63.)

The Commissioner took no position in the Tax Court on the depletion issue, the only one now remaining, beyond agreeing that either Paragon or the contractors were entitled to the depletion deduction, but not both (CIR Pet. App. 63).

The Tax Court held (CIR Pet. App. 63-72) that, under the rule of *Parsons* v. *Smith,* 359 U.S. 215, Paragon alone was entitled to the depletion deduction. After making the findings outlined above, the Tax Court said in its opinion (CIR Pet. App. 70-71), "While we cannot find that the right to terminate was specifically mentioned when the agreements were made, neither can we conclude that the agreements were nonterminable.

"On the facts in this case we conclude that the contractors could look only to the difference in their cost of mining the coal and the amount Paragon paid them for a return of their investment, that they made no investment in and acquired no economic interest in the coal in place, and that consequently they are not entitled to depletion on the coal they produced." Decision was entered accordingly (CIR Pet. App. 73-74).

F. Proceedings in and holding of the court below

The contractors—the Merritts *et als.*—petitioned for review in the court below, but at that stage the Commissioner abandoned neutrality, and supported Paragon's sole right to the depletion allowance. The Commissioner's points were these (CIR Resp. Br. 4-19):

> "The Tax Court correctly held that the Merritt group is not entitled to percentage depletion on the payments they received from Paragon for extracting coal.
>
> "A. Whether the Merritt group acquired economic interests in the coal in place, so as to be entitled to depletion allowances, depends upon whether they made investments in the coal in place which were necessarily reduced as the coal was extracted.
>
> "B. Under the Tax Court's findings, the Merritt group made no investments in the coal in place which were necessarily reduced as the coal was extracted; their investments were not in any specified area or fraction of the coal in place, for they were not given the right to mine any particular area to exhaustion and were not obligated to mine any or all of the coal to exhaustion.
>
> "C. The Tax Court's findings are not clearly erroneous and therefore dispose of the case."

However, in order to protect the revenue and solely for that reason, the Commissioner filed a cross-petition to review the decision in favor of Paragon. He said in support of that cross-petition (CIR Pet. Br. 13-14):

> "Although the position of the Commissioner is essentially that of a stakeholder, it is our view that the Tax Court correctly decided this case. Since the Commissioner's petition from the adverse decision vis-a-vis Paragon is essentially a protective one, in the argument below we will only outline briefly our reasons for believing the decision below is correct."

Nonetheless, the court below reversed (Appendix A, *infra,* pp. A1-A6). After all but rewriting the terms of the oral agreement as those had been found by the Tax Court (pp. A4-A5), it concluded (p. A5) that "the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price. By virtue of those contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons* v. *Smith,* 359 U.S. 215 * * *."

REASONS FOR GRANTING THE WRIT

The decision below requires review because it is the culmination of a series of rulings by the Fourth Circuit that first whittled away and now completely sets aside a recent decision here, *Parsons* v. *Smith,* 359 U.S. 215, where this Court disapproved the rationale of earlier Fourth Circuit decisions on the precise issue. Now the court below has reverted to its previous doctrines, reviving in the process a fiction that this Court five years ago advisedly refused to indulge.

First. Parsons v. *Smith,* 359 U.S. 215, 220, unanimously reaffirmed the proposition that "the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." There, as here, the mining contracts (p. 224) "do not show or suggest that [the contractors] actually made any capital investment in the coal in place, or that the landowners were to or actually did in any way surrender to [the contractors] any part of their capital interest in the coal in place. [The contractors] do not factually assert otherwise. Their claim to the contrary is based wholly upon an asserted legal fiction. As stated, they claim that their contractual right to mine coal from the designated lands and the use of their equipment,

organizations and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place." Accordingly, this Court denied the contractors in *Parsons* any deduction for depletion.

Accord, United States v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86: "Depletion, as we have said, is an allowance for the exhaustion of capital assets. It is not a subsidy to manufacturers or the high-cost mine operator."

The foregoing rationale necessarily disapproved the Fourth Circuit's earlier reasoning, both as to the purpose of the deduction and as to the nature of the requisite investment, as that reasoning appeared in a number of its decisions antedating *Parsons*. In those earlier decisions the court below had held that an "economic interest in the operation," based not on investment in the coal in place but upon investment in machinery and equipment, entitled the coal contractors to depletion in coal it never owned, on the footing that "they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset." *Commissioner* v. *Gregory Run Coal Co.*, 212 F. 2d 52, 55, 61, certiorari denied, 348 U.S. 828; *Weirton Ice & Coal Supp. Co.* v. *Commissioner*, 231 F. 2d 531, 535; *Commissioner* v. *Hamill Coal Corp.*, 239 F. 2d 347, 350-351; *Stillwell* v. *United States*, 250 F. 2d 736.

2. The rationale of *Parsons* was followed by the Third Circuit in *Denise Coal Company* v. *Commissioner*, 271 F. 2d 930, and by the Tax Court in a whole series of cases, including the present one. *Utah Alloy Ores, Inc.*, 33 T.C. 917; *Walter Bernard McCall*, 37 T.C. 674; *J. Shelton Bolling*, 37 T.C. 754; *William M. Legg*, 39 T.C. 30; *Raymond E. Cooper*, 39 T.C. 253; *Robert Lee Merritt*, 39 T.C. 257 (the present case); *Elm Development Co.*, 21 TCM 239; *Raymond C. Desrosiers*, 21 TCM 264; *Cecil C. Lawson*, TCM 1963-179 (CCH Dec. 26,203(M); P-H ¶63,179); *W.*

P. Isom, TCM 1963-308 (CCH Dec. 26,403(M); P-H ¶63,308).

But the Fourth Circuit has—with a single exception, now quite without vitality—significantly failed to follow *Parsons* as written.

(i) In *United States* v. *Stallard,* 273 F. 2d 847, although denying depletion to taxpayers who mined coal under contract, it reduced the seven factors set out in *Parsons,* 359 U.S. at 225, to the single factor of terminability.

(ii) In *Elm Development Company* v. *Commissioner,* 315 F. 2d 488, the contract plainly negatived any ownership of the coal by the contractor at any time.[3] The Commissioner accordingly argued (Br. 9-35) that "The Tax Court correctly concluded that Elm Development Company had no investment interest in the coal in place on Lorado's leasehold." But the Fourth Circuit allowed depletion to the contractor none the less, on the ground that the contract was terminable only for its default or lack of profitability to the lessee, concluding (315 F. 2d at 491) that when the contract is not terminable at will or on short notice, "the mining company has been granted a right in the coal in place; that is, the right to mine till exhaustion."

(iii) in *Cooper* v. *Commissioner,* 330 F. 2d 163, decided simultaneously with and on the authority of the present case, where the Tax Court had found as a fact on con-

[3] We quote the following from R. 9a in that case, as set forth at pp. 13-14 of the Commissioner's brief there:

"Title to all coal mined and delivered by the Contractor shall at all times, from the time of its severance until its sale by the Company, remain in the Company and Contractor shall have no interest in the coal or in any proceeds from the sale thereof.

"All obligations of the Company to make payments to Contractor hereunder shall be obligations owed by the Company to be paid out of its funds or assets and Contractor shall have no lien or charge against any of the coal produced by it or against the proceeds from the sale thereof."

flicting evidence that the contracts were subject to termination by the lessee (39 T.C. at 256), the Fourth Circuit none the less reversed and held the contractors entitled to depletion.

(iv) In the present case, in the teeth of findings by the Tax Court that clearly negatived any conveyance to the contractors, or any ownership by them of the coal either in place or after extraction, the Fourth Circuit, brushing aside a finding that there was no right to mine to exhaustion (CIR Pet. App. 61),[4] found (*infra*, p. A5) "the intent of the parties to vest in the operators a right to mine to exhaustion" none the less. Further, emphasizing (*infra*, p. A4) that "The parties contemplated that the operators would, and the evidence shows that they did, engage in large expenditures of time and money in preparing their respective sites for mining," the court concluded that (*infra*, p. A5) "By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons* v. *Smith*, 359 U.S. 215 * * *."[5]

Otherwise stated, the court below, while paying the lip service of citation to this Court's decision, has revived the fiction there laid, has ignored its rationale that the deduction for depletion inures only to those who have ownership of and capital investment in the mineral in place, and has in consequence effectively nullified its holding.

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[4] In *Stilwell* v. *United States*, 250 F. 2d 736, 739, a pre-*Parsons* case involving another of petitioner's contractors, the Fourth Circuit proceeded on the basis that the contract was not terminable—disregarding utterly a specific finding of fact by the district court that "The contract entered into between plaintiffs and Paragon was terminable at the will of either party" (Fdg. 14, 152 F. Supp. 111, 113).

[5] In *McCall* v. *Commissioner*, 312 F. 2d 699, the court below came closest to full acceptance of the ownership concept of *Parsons*. But the opinion there, written by a district judge, has not been followed since, as the text above clearly demonstrates.

Second. This case does not turn on facts, nor does it involve a congeries of disparate facts. The findings of the Tax Court establish the presence of six out of the seven factors relied on in *Parsons,* 359 U.S. at 225, and the sworn *ante motam litem* statements of G. Wesley Parsons on behalf of all the taxpayer contractors (CIR Pet. App. 80, 87, quoted *supra,* p. 7) sufficiently establish the seventh *Parsons* factor, terminability. Inasmuch as the leases here (CIR Pet. App. 55) "required the lessee [Paragon, petitioner here] to mine either all or 85 percent of the minable coal in and underlying the tracts under lease," there was, as a matter both of State and general law (13 Michie's *Jurisprudence of Virginia and West Virginia* 25-26 [Mines and Minerals, §14, and cases there cited]), an actual sale to petitioner of the coal in place. Very plainly, therefore the contractors had no property in that coal. For, as the Tax Court found, the contractors here did not assume any of petitioner's obligation under those leases (CIR Pet. App. 58), they paid no taxes on the property (*ibid.*) as owners of a mineral interest were required by State law to do (Va. Code, §58-774, *infra,* p. A10), and they acquired no legal title to the coal in place (CIR Pet. App. 62), as petitioner did here. In short, see *Parsons* at p. 225, item 4, "the landowners did not agree to surrender and did not actually surrender to [the contractors] any capital interest in the coal in place."[6]

[6] It should be pointed out that neither this case nor any of the others dealing with coal depletion involve that fractionalization of interests that is so characteristic in the oil and gas situation. E.g., *Palmer* v. *Bender,* 287 U.S. 551; *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362; *Anderson* v. *Helvering,* 310 U.S. 404; *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25.

Accordingly, we have not particularized the holdings in recent oil and gas depletion cases involving problems similar to the one now considered. *Scofield* v. *LaGloria Oil and Gas Co.,* 268 F. 2d 699 (C.A. 5), certiorari denied, 361 U.S. 933; *CBN Corporation* v. *United States,* 328 F. 2d 316 (C.Cls.); *United States* v. *Thomas,* 329 F. 2d 119 (C.A. 9).

Moreover, quite apart from the two factual issues here that were contested below,[7] the totality of the undisputed and indisputable facts establishes conclusively that these contractors did not own a single lump of coal when their work commenced, and did not own a single lump when they finished. They are therefore not entitled to depletion, for the obvious reason that no part of their property and no part of their capital investment in coal in place was ever depleted by their mining operations.

Property, and property alone, is the touchstone entitling to depletion; that has been true, from *United States* v. *Ludey*, 274 U.S. 295, 302, through *Thomas* v. *Perkins*, 301 U.S. 655, 663 ("Ownership was essential"), *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366-369, and *Parsons* v. *Smith*, 359 U.S. 215, 220, down to §614(a), I.R.C. 1954 (*infra*, p. A8), and §1.611-1(b)(1) of the current regulations (*infra*, p. A10).

Here the undisputed facts negative any property interest whatever in the coal on the part of the contractors, and likewise negative any investment by them in the coal in place. We are confirmed in this view by the circumstance that the Commissioner in this case, though technically a stakeholder, argued vigorously on our side below (*supra*, p. 10), as indeed he had similarly argued on the side of the lessee in the *Elm Development* case (*supra*, p. 13). All of the other facts and factors discussed in the decisions are significant only as indicia of property and capital investment in mineral in place.

Accordingly, the basic question here is whether the doctrine of *Parsons* v. *Smith* will be enforced—or whether the Fourth Circuit will be permitted to reapply its pre-

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[7] (1) Terminability—where the Tax Court failed to find a fact sworn to on behalf of all the parties adverse to petitioner long before the litigation started; (2) the asserted right to mine to exhaustion—where the court below set aside a finding made by the Tax Court on conflicting evidence.

Parsons view (*Commissioner* v. *Gregory Run Coal Co.*, 212 F. 2d 52, 55, 61, *supra*) that (a) it is sufficient for the contractor to have "an economic interest in the operation," rather than in the coal in place as required by *Parsons;* and to reapply its other pre-*Parsons* view that (b) the statute was "designed to give compensation to persons interested in the production of a wasting asset," rather than, as held in *Parsons,* that its purpose was "to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset," and as held in *Cannelton Sewer Pipe,* that it was "an allowance for the exhaustion of capital assets."

As matters now stand, *Parsons* v. *Smith* is not law in the Fourth Circuit, where the great majority of the mining contract cases have arisen—and will in future arise if the present decision goes unreviewed.

Third. In reverting to its earlier views on coal depletion in the present case, the Fourth Circuit further overlooked the circumstance, duly pressed upon it in argument and brief, that under existing statute law, in force during the taxable years here in question, there was no warrant for allowing any percentage depletion to one who merely had a contract to mine coal—and of course the deduction for depletion, like all other deductions, is a matter of legislative grace. *Parsons* v. *Smith,* 359 U.S. at 219 and cases cited in note 5.

1. Section 611(b)(1), I.R.C. 1954 (*infra,* p. A7), carrying forward a provision in force since 1918,[8] provides that, in the case of a lease, the deduction for depletion "shall be equitably apportioned between the lessor and lessee."

But §631(c) (*infra,* p. A9), which grants a coal lessor capital gains treatment for his royalties, goes on to pro-

[8] Rev. Act of 1918 and 1921, §214(a)(10); Rev. Acts of 1924 and 1926, § 214(a)(9); Rev. Acts of 1928 and 1932, § 23(l); Rev. Acts of 1934, 1936, and 1938, §23(m); I.R.C. 1939, §23(m).

vide that "Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal."

That is to say, there is no longer any statutory basis for apportionment of the depletion allowance with respect to coal leases: the lessee, petitioner here, is entitled to the entire allowance. And here, of course, it cannot possibly be contended that petitioner's arrangements with its contractors were leases in any sense.

2. The contractors' lack of entitlement to any deduction for depletion is further emphasized by two other statutory provisions.

(a) The timber depletion subsection, §631(b) (*infra*, p. A8 at A9) defines "owner" for the purpose of computing the depletion allowance as "any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber." But the coal depletion subsection, §631(c) (*infra*, p. A9), defines the same word for the same purpose as "any person who owns an economic interest in coal in place, including a sublessor."

That is to say, Congress well knew the distinction between the owner of an economic interest and the holder of a contract to cut. If it had intended to extend benefits to the holder of a contract to mine coal, it could easily have said so.

(b) Section 614(a), *infra*, p. A8, defines property for the purpose of computing the depletion allowance in the case of mines, as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

Here, very plainly, since none of the contractors owned any interest whatever in the mineral deposits in question, they did not qualify under the statute. The "economic interest" granted them by the court below not only can-

not rise above the level of a semanticized fiction, it is denied them on a plain reading of the statute law.[9]

Fourth. The decision below if permitted to stand will have serious litigation-breeding consequences. As the Commissioner said in the *Elm Development* case, 315 F. 2d 488, *supra*, "The continued substantial volume of depletion litigation undertaken by coal contractors subsequent to the Supreme Court's decision in *Parsons* v. *Smith,* 359 U.S. 215, is nothing less than 'a tribute to the tenacity of the American taxpayer'" (CIR Br., p. 9).

Now, with *Parsons* v. *Smith* disregarded in the Fourth Circuit—where most of the coal contractor cases arise—that volume of depletion litigation will assuredly increase, and at all levels: Every individual mining coal under contract in the hills of Virginia and West Virginia, encouraged by the recent decisions, will claim a deduction for depletion, regardless of the terms of his contract; refund claims in large numbers will assuredly be filed by taxpayers who had, up to now, assumed that *Parsons* foreclosed them; where contractors have succeeded in obtaining deductions from the court below in disregard of the *Parsons* principles, fee owners and coal lessees whose returns are still open may be expected to pay under protest and sue in the Court of Claims, where their contractors' earlier success cannot bar them; and in the Tax Court, which has faithfully followed and applied *Parsons*, see cases cited *supra* at pp. 12-13, only to be reversed at least three times by the

[9] The provisions herein discussed giving coal lessors capital gains treatment of royalties were not enacted until after the taxable years considered in *Parsons* v. *Smith*. See Section 325(b) of the Revenue Act of 1951, amending §117(k)(2), I.R.C. 1939. In 1954, sublessors of coal were included as beneficiaries, to obviate the decision in *Island Creek Coal Co.,* 30 T.C. 370, while § 614(a), I.R.C. 1954 (*infra*, p. A8), which defines "property" for purposes of depletion, restated in legislative form what had previously rested only on regulation. Treas. Reg. 111, § 29.23(m)-1(i).

court below in consequence,[10] near chaos may be anticipated. For—and this is the nub of the matter—the principles that all concerned believed to have been settled by *Parsons* v. *Smith* are nullities in the circuit in which the bulk of the country's contract coal mining takes place.

CONCLUSION

This Court's writ in coal depletion cases does not now run in the Fourth Circuit. The present petition for certiorari should therefore be granted.

Respectfully submitted.

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June 1964.

[10] *Elm Development Co.*, 21 TCM 239, reversed, 315 F. 2d 488; *Raymond E. Cooper*, 39 T.C. 253, reversed, 330 F. 2d 163; *Robert Lee Merritt*, 39 T.C. 257, reversed, 330 F. 2d 161 (*infra*, pp. A1-A5).

APPENDIX A

Opinion Below

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9179.

Robert Lee Merritt and Winnie Merritt;
G. Wesley Merritt and Fannie J. Merritt;
Jack D. Merritt and Willa Gray Merritt;
Virginia Bowling and Gladys Bowling, and
James O. Watson, 3rd, and Lucy J. Watson,
Petitioners,

versus

Commissioner of Internal Revenue,
Respondent,

and

Commissioner of Internal Revenue,
Petitioner,

versus

Paragon Jewel Coal Company, Inc.,
Respondent.

On Petitions to Review the Decisions of the Tax Court of the United States.

(Argued January 13, 1964. Decided March 17, 1964.)

Before Haynsworth, Bryan and J. Spencer Bell, Circuit Judges.

John Y. Merrell for Petitioners, Taxpayers; Michael Mulroney, Attorney, Department of Justice, (Louis F. Oberdorfer, Assistant Attorney General, and Lee A. Jackson and Melva M. Graney, Attorneys, Department of Justice, on brief) for Commissioner of Internal Revenue, and Frederick Bernays Wiener (Leroy Katz and Carl C. Gillespie on brief) for Respondent, Paragon Jewel Coal Co., Inc.

J. SPENCER BELL, Circuit Judge:

These are consolidated appeals from the Tax Court. The issue is whether the lessee, Paragon Jewell Coal Company, Inc. [hereinafter referred to as Paragon], is entitled to the entire depletion deduction on the coal mined from its leased property or whether the several contract mine operators, petitioners in this action [hereinafter referred to as the operators], are entitled to a part of that depletion deduction based upon the amounts received by them respectively for the coal which each of them mined under agreements with Paragon. The Tax Court, which heard the cases together, decided that the lessee, Paragon, was entitled to the entire percentage depletion deduction. The operators appeal, contending that Paragon is required to share the deduction with them. The Commissioner, who took a neutral position as between the petitioners and Paragon before the Tax Court, appeals the decision in Paragon's case in order to protect his position as a stakeholder, conceding that either the operators or the lessee is entitled to the deduction, but not both.

Since the Commissioner concedes that either the operators or the lessee, Paragon, is entitled to the deduction, we find it unnecessary to go into all of the factual background, but shall confine ourselves to that part which we consider relevant to a decision of the issue between the parties. Paragon is the assignee of certain leases of coal bearing

lands under which it has paid minimum royalties, tonnage royalties and land taxes. It has made substantial investments on the properties in order to prepare itself to process, ship and market the coal which was produced. Paragon's experience was as a processor and seller of coal rather than a producer; furthermore it lacked the capital to go into the producing end of the business. Rather than mine the coal itself, it entered into oral agreements with the petitioning operators and others to mine the coal by a method known as drift mining.[1] In addition to the equipment necessary for storing and processing the coal, Paragon installed a road running around the monutain close to the outcrop line of the coal over which the coal could be trucked from the mines to Paragon's tipple, where Paragon cleaned, sized and sold the coal.

Beginning with the Stilwells in 1951 (who are not petitioners here), Paragon entered into oral leases with a number of operators, all of which were similar in terms. Under the agreement an operator would be allocated a specific surface area under which it might mine. The allocation was made either by pointing it out on the ground or by showing it to him on the over-all property map. The operator agreed to mine the coal within that area and deliver it to Paragon at the operator's own expense. All expenses of opening and operating the mines were borne by the several operators. Paragon agreed to pay a fixed price at the tipple, but it was understood that the price would, and in fact it did, vary with the market. The operators were required to use and pay for the services of Paragon's engineer and to operate and maintain their mines in accordance with state and federal regulations. The contracts were silent as to who was entitled to deple-

[1] Drift mining is done by driving a hozizontal shaft into the hillside in order to extract the coal from seams which are usually less than three feet in thickness. The process is a difficult and economically marginal operation.

tion. They contained no termination date and nothing was said between the parties on this subject. The Tax Court found that:

> It was anticipated by both parties that a contractor [contract mine operator] would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit and as long as the contractor employed proper mining methods and produced coal meeting Paragon's specifications.

Because the contracts did not contain a specific statement that they were *not* terminable at the will of Paragon and because they did not contain a specific statement that the operator had a right or obligation to mine to exhaustion, the Tax Court concluded that as a matter of law the operators did not under the contracts have such rights.

We must disagree with the Tax Court's conclusions of law. Its own findings as to the intent of the parties quoted above negates its conclusions as to the legal rights of the parties under the contract. The parties contemplated that the operators would, and the evidence shows that they did, engage in large expenditures of time and money in preparing their respective sites for mining. We think the Tax Court was in error in concluding that because the oral contracts were silent on the point, the operators did not possess a non-terminable *right* to mine to exhaustion, especially in the face of the court's finding of an intent on the part of the parties to the contrary. It would be inequitable indeed to hold that Paragon might remain silent on this point until the operators had invested their time and money and then take the benefit of the operators' efforts at will and without cause. The burden was on Paragon to express the limitation, if any. *Jack's Cookie Co.* v. *Brooks*, 227 F.2d 935 (4 Cir. 1955), *cert. denied*, 351 U.S. 908 (1956). Paragon was under obligation to mine the property. These operators were performing Paragon's

obligation under its leases and this constituted ample consideration running from the operators to Paragon to make their mutual intentions with respect to the contract binding on Paragon. The fact that the contracts did not fix upon the operators an *obligation* to mine to exhaustion does not vitiate the binding effect of the intent of the parties to vest in the operators a *right* to mine to exhaustion. That the operators could cease mining would not destroy the mutuality. *Phillips Petroleum Co.* v. *Buster*, 241 F.2d 178 (10 Cir.), *cert. denied*, 355 U.S. 816 (1957).

Thus we see under this interpretation of the contracts, the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price. By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons* v. *Smith*, 359 U.S. 215 (1959); *Elm Dev. Co.* v. *Commissioner*, 315 F.2d 488 (4 Cir. 1963); and *Stilwell* v. *United States*, 250 F.2d 736 (4 Cir. 1957).[2] The Tax Court's decisions are reversed and the cases remanded for entry of an order in conformity with this opinion.

Reversed and Remanded.

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[2] Indeed the *Stilwell* case arose out of the same facts, although of course the record being different, it is not *res judicata*.

APPENDIX B

Judgment Below

Filed and Entered, March 17, 1964

[Caption omitted]

THIS CAUSE came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court of the United States, in this cause, be, and the same are hereby, reversed; and that this cause be, and the same is hereby, remanded to the Tax Court of the United States for the entry of an order in conformity with the opinion of the Court filed herein.

/s/ CLEMENT F. HAYNSWORTH, JR.
United States Circuit Judge.

/s/ ALBERT V. BRYAN
United States Circuit Judge.

/s/ J. SPENCER BELL
United States Circuit Judge.

APPENDIX C

Statutes and Regulations Involved

1. Sections 611 (a) and (b), I.R.C. 1954, as amended, are as follows:

Sec. 611. Allowance of deduction for depletion

"**(a) General rule.**—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletition and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

"**(b) Special rules.**—

"**(1) Leases.**—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

"**(2) Life tenant and remainderman.**—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

"**(3) Property held in trust.**—In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the

trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"(4) **Property held by estate.**—In the case of an estate, the deduction under this section shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each."

2. Section 613(a), I.R.C. 1954, is as follows:

"**§ 613. Percentage depletion**

"(a) **General rule.**—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section."

3. Section 614(a), I.R.C. 1954, is as follows:

"**§ 614. Definition of property**

"(a) **General rule.**—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each separate tract or parcel of mineral deposit in each separate tract or parcel of land."

4. Sections 631(b) and (c), I.R.C. 1954, are as follows:

"**§ 631. Gain or loss in the case of timber or coal**

* * * * *

"(b) **Disposal of timber with a retained economic interest.**—In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such

timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term 'owner' means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

"(c) **Disposal of coal with a retained economic interest.**—In the case of the disposal of coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word 'owner' means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying sub-chapter G, relating to corporations used

to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b) (6) or section 545(b) (5))."

5. The third paragraph of Section 58-774 of the Code of Virginia provides as follows:

"If the surface of the land is held by one person and the coal, iron and other minerals, mineral waters, gas or oil under the surface be held by another person, the estate of each and the relative fair market value of their respective interests shall be ascertained by the commissioner [of revenue of the respective county]."

6. Section 1.611-1(b)(1) of the Regulations under I.R.C. 1954 is as follows:

"**NATURAL RESOURCES**

"**§ 1.611-1 Allowance of deduction for depletion**

* * * * *

"**(b) Economic interest.** (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders."